PRIVATE EQUITY PERFORMANCE IMPROVEMENT

Transparency in Reporting Key Performance Indicators (KPI)

Years ago, patrons preferred to wait in excitement before their meal arrived, but after plenty of food horror stories, diners now want more transparency into what's going on in the kitchen. Restaurants—ranging from fast casual to Michelin starred—have recently deployed open kitchens. What started out as a desire to leverage space while entertaining, is now a way to provide comfort to diners.

Key performance indicators (KPIs), like open kitchens, provide transparency, which feeds the desire to know that the organization is delivering on the performance they promised. The KPIs are, in essence, the equivalent of the open kitchen dining concept. When a company cares about its stakeholders, like restaurants care about their diners, they want to provide accuracy, usability, and transparency when deploying KPIs and monitoring performance against them.

The open kitchen concept not only improves the dining experience, but also improves the performance of the kitchen staff by helping them to control the customer experience. Full transparency drives behavior and ultimately allows the restaurant to improve its performance. The restaurant's main goal is to influence the result and ensure there are no surprises to the customer. Likewise, organizations can leverage KPIs to drive transparency and alignment on desired outcomes. KPIs are one of the primary tools organizations use to drive accountability and measure progress towards their goals. In order to effectively utilize KPIs, organizations need to ***identify*** the most impactful KPIs, ***activate*** the KPIs to drive operational improvement by deploying it throughout the organization to ensure that there is consistent application of the KPIs, and ***monitor*** the progress (adapting as needed).

Identify

Two types of data are required for effective KPIs. When developing an inventory of KPIs, it's important to understand the distinction:

Type 1: Data with *feedback value.* Data has feedback value when it can be used to confirm previous trends. Lagging indicators have feedback value.

Type 2: Data with *predictive value*. Data has predictive value when it can be used to plan future trends. Leading indicators have predictive value.

In leading organizations, big data, analytics, and data science are used to identify and prioritize metrics that matter the most. KPIs will be different for every company, even within the same industry. It's not a one-size fits all exercise and many times the most effective KPIs do not have dollar signs in front of them.

Recently, we supported a manufacturing client that wanted to improve profitability. The sales team had been driving shifts in production and subsequently increasing the number of machine turnovers to meet customer demands. The increase in machine turnovers were driving inefficiencies in production and were triggering the sales, inventory, and operations planning activities to be out of balance. The client used big data and analytics instead of the conventional KPIs they used and were able to identify raw materials efficiency as one of the key leading indicators of profitability. By deploying and monitoring material efficiency, they were able to identify plants and products where improvements in raw materials efficiency yielded improvements (beyond raw materials savings); and were able to capture additional downstream labor savings through the deployment of enhanced handling processes.

In addition, by providing transparency via dashboards and closely monitoring material efficiency, they were able to get a three-month window into profitability, which allowed them to shift production to more profitable products. Plus, the reduction in machine turnover improved the quality of the products and provided the sales team the ability to more accurately communicate delivery windows to their customers. Through the use of data and analytics, they identified a key operational lever within the plant that was easy to understand and allowed for targeted operational improvements, which in turn improved their profitability.

A challenge organizations face when selecting KPIs: Having to avoid developing an unwieldy inventory of KPIs (KPI overload). What's the right number of KPI to deploy? There isn't a precise number, but it's likely fewer than most organizations use—leading organizations deploy between four and ten. It's important to note that KPIs are the measures within a business that identify which levers get pulled in order to effect change. Performance indicators, on the other hand, are a measure of how an organization, team, or individual is performing, but do not necessarily effect change. As a result, it's important to have a structured and thoughtful process to select KPIs and develop tightly linked performance indicators.

Activate

Once an organization identifies the inventory of KPIs driving the business, the next step is to prioritize the KPIs. This step involves feedback value and predictive value. In the current environment, where customer behaviors and interaction models are constantly changing, being able to identify these types of shifts early, and then predict future changes is becoming table stakes. Now, organizations are forced to take on increased scenario and what-if planning activities. The past is becoming a diminishing indicator of the future.

In order to effect change within the organization, it's important to prioritize KPIs with strong predictive value. Organizations must identify the KPIs in their business with predictive value to proactively manage the risks and take advantage of the opportunities ahead. Identifying KPIs with predictive value often requires advanced statistics and algorithms to identify significant, repeatable patterns.

In 2012, the New York Times featured a story on how Target leveraged big data and analytics to develop a pregnancy prediction score allowing them to send targeted marketing to pregnant women (e.g. coupons for diapers, cribs, baby clothes, etc.). This, in turn, drove increased volume of their new-mother and baby products. To develop an accurate prediction, Target had to go beyond the traditional consumer-based KPIs. Identifying the right KPIs required spending a significant amount of time on analysis to find the trends and commonalities in the data that ultimately allowed them, with a high degree of accuracy (95%), to predict if a shopper was pregnant within the first 20 weeks of their pregnancy and dramatically increased the sales of their new-mother and baby products through targeted promotions. This required analysis of hundreds of products to identify the roughly 25 products that yielded the highest level of predictive capabilities. While controversial at the time, this is now commonplace, and is the preferred approach by leading organizations to identify the datasets that have the highest predictive value.

Identifying and prioritizing KPIs requires an organization to be proactive and develop a strategy to continuously monitor their data. The focus of the organization needs to extend beyond using KPIs to answer known questions. Organizations must experiment and discover trends that help them consider new risks and opportunities. Once the organization has a prioritized set of enterprise level KPIs, these indicators should be cascaded through and aligned with the rest of the organization down to the individuals using performance indicators.

Monitor

In top performing organizations, KPIs are leveraged to lead change as well as manage it. Organizational level KPIs should be used to inform strategic level decisions and day-to-day decision making. They should be an indication of how the leadership team and organization will hold themselves accountable. Careful consideration should be given to how the enterprise KPIs—"The Game Plan for Success"—impact the various flows of the business and how performance measures and targets can be used to develop functional scorecards.

A challenge organizations are facing: As they begin to drive performance at the individual level, this can lead to undesired outcomes at the organizational level. Therefore, it's critical to evaluate the cause and effect relationship between the performance indicators.

Empowering self-organization around KPIs and associated performance indicators is an important leadership principle. Effective leaders recognize enhanced transparency is required to ensure appropriate KPI alignment between customers, partners, teams, as well as between enterprise imperatives and individual talents. Big data and analytical capabilities are critical to continuously monitor the drivers within the business that effect change and allow proactive changes in customer behaviors. Identifying the relationships and interdependencies between KPIs is critical to developing transparency and alignment throughout the organization; deploying the right KPIs, and associated performance indicators, is required to drive the desired behaviors.

Case in Point

A recent client was in the middle of a M&A transaction and was feeling pressure from the impacts of the COVID pandemic. A significant portion of the business was driven by the academic sector and as the sector shifted to remote learning, it needed to identify opportunities to drive improvements in its cash flow. The client knew it was experiencing issues with an overall high days inventory outstanding (DIO), but working capital metrics were not monitored closely and were increasing above historical and best in class levels.

In the area of inventory management, the client identified the relevant KPI being DIO, but was unable to pinpoint the deterioration or to develop improvement plans to address it. As in the Target example, the client dug deeper and utilized statistical analysis of historical data at the location, customer, product, and SKU level to discover the need to drill down further and look at DIO at the parts and equipment levels discretely. Prior to this exercise, it had only looked at turns in aggregate for parts and equipment. By understanding the underlying drivers at a more detailed level, the client was able to develop plans to rapidly improve DIO and overall working capital. The client deployed a hub and spoke strategy for equipment inventory and leveraged that same strategy to remove parts from their maintenance trucks to reduce existing inventory while enhancing the processes for ordering and stocking parts. The improvements that were implemented into the inventory KPIs helped the client identify $70+ million of potential working capital improvements (during a critical time of reduced revenues and increased uncertainty caused by COVID).

Transparency, into the core KPIs and related drivers, shaped a change in behavior within the business and supported more informed decision making; and allowed increased level of precision in developing and tracking KPIs by identifying the individuals within the organization that were closer to the identified cost savings and improvement opportunities. For example, by providing visibility to the KPIs to the maintenance truck drivers, the organization uncovered the existence of obsolete and unnecessary parts, which made up a significant portion of the parts on hand, and ultimately through actively managing the related KPIs, yielded significant savings in inventory carrying costs.

Improvements to inventory led to immediate lifts in other areas of working capital, which resulted in a favorable cash position of $40+ million and a 57 percent improvement in annual cash flow performance. To further ensure alignment on the desired outcomes, components of the business leaders' annual bonuses were tied to the newly established KPIs. Developing precision around the leading indicators with higher predictive value and leveraging incentive compensation to drive the desired behavior freed up additional capital and allowed the client to play offense during the pandemic when the competition was playing defense.

The client identified the refined KPIs using data and analytics to find the root cause of the issues; activated a set of KPI benchmarks and deployed them to appropriate levels within the business to drive the desired behavior; and used detailed improvement plans and related reporting to monitor progress. Just like in the open kitchen concept, it was the transparency into the key performance indicators that was the catalyst for change. The client desired to provide accuracy, usability, and transparency when deploying their KPIs and monitoring performance against them. Full transparency drove the desired behavior and allowed the client to improve its performance. Ultimately, the client was able to influence the results and ensure there were no additional surprises.

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